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SIPDIS

SENSITIVE

DEPARTMENT FOR WHA/CEN
DEPARTMENT PASS USTR, OPIC AND EX-IM BANK

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TAGS: ECON EFIN NU IMF
SUBJECT: PRESSURE INCREASES ON NICARAGUA TO RESOLVE IMF ISSUE

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¶B. MANAGUA 1011

¶1. (SBU) SUMMARY. A strong message from European donors has increased the pressure on the GON to take action to awaken the "dormant" IMF program or jeopardize losing USD 120 million in aid, including direct budget support. This echoes similar comments from Carlos Castaneda, IDB Executive Director for Central America, who on May 23 called for an IMF agreement to help Nicaragua maintain its macroeconomic stability. Because the IMF program is on hold, Nicaragua has lost USD 71 million in planned disbursements from the IDB and IMF to date. In order for an agreement, that would extend the current program through 2006 to be presented to the IMF Board in August, the GON needs to finalize budget reform and reach consensus with the National Assembly on structural reform immediately. If the GON fails to submit the program by the first week in June, the GON will have to start negotiations over with the IMF in 2006. The GON estimates that USD 175 million in aid is at risk for 2005. The fiscal reform package continues to be held hostage to the political debate between the National Assembly and the Executive. END SUMMARY.

BACKGROUND: THE IMF PROGRAM

¶2. (SBU) At a May 4 International Donors Meeting ("Mesa Global"), Finance Minister Mario Arana provided background on the current budget reform impasse for major donors. He recalled how in December 2004, the National Assembly increased spending by about 700 million cordobas (about USD 42 million), or 0.8 percent of GDP, above the IMF guidelines (ref A). The spending gap came from salary increases for health and education workers, increased transfers to other branches of government, and increased transfers to municipalities (estimated at 180 million cordobas). However, the National Assembly was quickly persuaded that the IMF would not accept this, and negotiations began on how to cover the spending gap. In April, the Executive and the National Assembly reached an agreement on a fiscal package of around 300 million cordobas in new revenues by ending special tax treatment for banks, introducing taxation on casinos, and reducing tax exonerations, especially for luxury goods. With revenue projections restated for another 250 million cordobas, the gap was almost closed.

¶3. (SBU) Arana explained that although the tax reforms passed, the National Assembly added a provision that had not been discussed or agreed to by the Executive, implementing a constitutional reform to permit taxation of media inputs and capping the media's tax exonerations (ref B). When the Executive reviewed the law they determined that the media amendment had not been agreed, was controversial and politically sensitive, and had not been discussed with the affected sector. The President vetoed this article with the hopes of opening the way to an alternative tax proposal acceptable to the media sector - a positive list of tax-exempt inputs. Arana explained that although initially both the FSLN and the PLC indicated that they would be open to a discussion, they backtracked and argued that the President should first remove his veto before any discussion. The situation has been at an impasse for over a month.

MACROECONOMIC SITUATION

¶4. (SBU) In response to Arana's May 4 presentation on the political background surrounding the IMF program, Humberto Arbulu, IMF Resident Representative, provided his perspective on the situation for the donors. He indicated that Nicaragua was on track as far as statistical figures based on the current macroeconomic situation. He added that 2004's economic growth was stronger than expected, and inflation was under double digits. On the fiscal side, Nicaragua enjoyed increases in tax revenue and more social spending. On the monetary side, there was more reserve growth than expected last year. In the financial system, there was a decline in interest rates for loans and deposits. Banks are stronger, more highly capitalized and more profitable, with better loan

loss reserves and smaller portfolios of non-performing loans. On the external side, exports recovered strongly and remittances increased in 2004. Regarding 2005, Arbulu felt that growth (measured by the IMAE indicator) remained good, and inflation was slightly below previous year's levels. On the fiscal side, he said tax revenues were better than targeted and tax administration showed good results. He felt that bank consolidation had strengthened the financial system. Finally, on the external side, exports were growing at 22 percent annual rate and imports at less than 16 percent annual rate.

¶5. (SBU) According to Arbulu, the IMF understands that the political situation cannot always be molded to fit the bureaucratic needs of the IMF. He has stressed that the GON needs to get budget reform finalized and get buy-in from the National Assembly immediately in the hopes of presenting an agreement to the IMF Board in August. However, Arbulu stated that Nicaragua could live without an IMF program because the macroeconomic indicators are satisfactory. He reiterated that if nothing happens soon, the GON will miss the opportunity to extend the current program and will have to start negotiations over in 2006. On May 23, Arana told the press that if the log jam could not be resolved within two weeks, their would be no IMF program. Arbulu, standing by his side, concurred.

EUROPEAN DONORS SPEAKS OUT FORCEFULLY (FINALLY)
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¶6. (SBU) On May 23, Carlos Castaneda, IDB's Executive Director for Central America and Belize, who was wrapping up a four day visit to Managua with the IDB Executive Board of Directors, encouraged the Executive and the National Assembly to take action as soon as possible to reach a consensus and allow the IMF agreement to go forward. In a press interview, Castaneda added that he saw "good will" on behalf of the Executive and the National Assembly to resolve the impasse and maintain Nicaragua's positive macroeconomic performance. Although he strongly encouraged the approval of the IMF program to maintain economic and political stability, Castaneda stated that, with or without an IMF agreement, the IDB was committed to Nicaragua and planned to invest a guaranteed USD 160 million in 2005 if the country maintained a stable macroeconomic situation. He added that only USD 35 million were dependent upon having an IMF agreement in place. Eduardo Balcarcel, IDB Resident Representative, explained that IDB loans will fund 30 projects including private sector credit programs, road and infrastructure projects, hospital modernization and health care programs, and other social programs.

¶7. (SBU) On May 24, Dutch Ambassador Kees P. Rade, speaking on behalf of the European donor community, stated that the Europeans were serious this time about suspending part of their aid to Nicaragua if the GON could not reach an agreement with the IMF. Rade added that although many people have felt that the Europeans have failed to live up to similar threats in the past, this case was different. In a press interview, Rade explained that the donor community had frozen budget support and announced a new donor mechanism which conditions further disbursements on macroeconomic and political stability, the development of budget mechanisms that guarantee confidence in the management of donor funds, and policies that promote economic growth and poverty reduction. The Dutch have euro 9 million in budget support on hold for 2005 pending the IMF agreement. Rade added that the Dutch government wants assurances of how its money is invested and they use the IMF agreement as a measurement instrument. Jurg Benz, Central American Representative for the Swiss Development Agency (COSUDE) and the new European donor coordinator, made similar comments about the need for substantive reforms and a framework to ensure fiscal responsibility in the future or else the budget gap could grow larger in 2006 and 2007.

COMMENT:

¶8. (SBU) If the GON wants the IMF Board to review a revised program at its August meeting, they will need to reach a political agreement with the National Assembly on the substantive issues by early June. The deadlock between the GON and National Assembly continues to impede an agreement on IMF requirements. The budget reform measures are being held hostage to the standoff over the media taxation reforms. If it were not for the politics, the issues would not be that difficult to solve, but political will is lacking to address some of the substantive reforms the IMF wants such as the financial administration law, fiscal responsibility law, and neutralizing municipal transfers. The FSLN and the PLC continue to manipulate the negotiations to pressure the Executive to accept the National Assembly's constitutional reforms. At this time, the IMF program is not officially "off track" but "dormant" in the words of Mario Alonso, Central Bank President. In fact, Alonso commented to CDA on May 19 that Nicaragua remains in compliance with IMF targets.

¶9. (SBU) Comment Cont. The public statements from the European donors about the importance of the IMF agreement and fiscal responsibility in general are most welcomed and support the Mission's efforts to promote macroeconomic stability and government transparency. Although Nicaragua's current macroeconomic situation is stable, the failure to reach an IMF agreement would have a negative impact on donor aid in the short term and a concomitant impact on the Nicaraguan budget in the long term. On May 25, the National Assembly approved the General Mediation and Arbitration Law, which could be a positive indicator. Meanwhile FSLN leader Daniel Ortega and his proxies have ratcheted up the political debate. In a May 25 declaration Ortega accused the international financial institutions (IFIs) of doing little to solve Nicaragua's social problems over the past 15 years and said he would not give in to their pressure. He blamed the IFIs for Nicaragua's energy crisis and said that structural reforms had actually worsened the economic situation for thousands of Nicaraguans who were forced to leave the country in search of jobs in Costa Rica and the U.S. On May 26, hard-line Sandinista Omar Cabezas, National Human Rights Prosecutor, also took out a one-page paid advertisement denouncing CAFTA and the neoliberal economic policies of the 1990s as violations of human rights. END COMMENT.

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